LH|M MONETARY POLICY ANALYTICS

December 19, 2018

Powell Under Pressure

There were many surprises coming out of the December FOMC meeting—in the statement, the macro and rates projections, and the press conference. However, we saw the overall message from the December FOMC meeting as consistent with how we had anticipated the FOMC's outlook would have changed since September, particularly given recent market turmoil and tightening in financial conditions. In particular, the FOMC remains optimistic about the U.S. economy and sees no reason to fundamentally reconsider the domestic outlook at this point. Somewhat softer growth abroad and meaningfully tighter financial conditions do warrant a somewhat shallower path of the funds rate to achieve similar economic outcomes, so the median dots fell by 25 basis points. However, with markets already expecting far less tightening than FOMC participants, Powell was careful not to lower those expectations even further. He certainly did not signal a March pause, but he also didn't signal a hike. Overall, we saw the outcome of the December FOMC meeting as supportive of our call of two hikes in 2018, in March and June—though with a meaningful probability of a pause in March.

The Statement

The statement surprised us.

- The first paragraph, which describes the incoming data, was very little changed. They said the unemployment "remained low" rather than "declined"—a necessary change given the data.

- They kept the sentence, "Indicators of longer-term inflation expectations are little changed, on balance." We had expected them to acknowledge a decline in market-based measures of inflation compensation, not because the FOMC would be especially concerned about this or want to send a dovish signal, but because the recent decline in five-year, five-year forward breakeven inflation rates seemed to be sharp enough to severely strain the "little changed" language.

- In the second paragraph, they opted to make a small adjustment to the "further gradual increases" language by adding the qualifier "some." We had thought they might take this opportunity to remove the reference to future hikes entirely. By doing it at this meeting, they could have pointed to the dots as clearly indicating a consensus that further hikes will be appropriate. Indeed, keeping "increases" points to multiple additional rate hikes. Instead, they'll have to keep debating and adjusting this language at upcoming meetings. In making this decision, the FOMC was likely influenced by a desire not to reinforce market doubts about rate hikes at upcoming meetings. A March hike is certainly on the table.

- Another change in the second paragraph was the addition of language saying that the FOMC "will continue to monitor global economic and financial developments and assess their implications for the economic outlook." This change was a surprise to us because in the past the FOMC has been hesitant to make such references in the statement. Viewed in isolation, that would suggest to us greater concern on the part of the FOMC about recent events. However, Powell was quite clear in the press conference that recent

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market volatility has not been enough for the FOMC to fundamentally reconsider its policy. Furthermore, the concern seems to be focused on external (not domestic) risks for the time being.

Macro Projections

FOMC participants' median macro projections showed an outlook that was broadly the same as in September. The themes for the 2018 and 2019 macro projections that Powell specifically highlighted were as expected: slightly softer core inflation and somewhat slower (but still-solid) real GDP growth. However, there were more revisions to the FOMC's median macro projections than we anticipated, though at this point we don't take a strong signal from those.

Growth

- The FOMC marked down 2018 real GDP growth a tenth, to 3.0%. We'd thought they'd continue to project 3.1%, but we don't see that discrepancy as meaningful.

- They marked down 2019 a couple tenths to 2.3%, as we expected, but didn't change 2020 and 2021 (2.0% and 1.8%, respectively). Powell explained that this downward revision reflected the tightening in financial conditions and a lower path of the funds rate, with the latter only partially offsetting the former. This was in line with the changes we made to our own forecast since September.

- The longer-run growth projection also edged up a tenth, to 1.9%.

Unemployment rate

- The median projected unemployment rate path for 2018 and 2019 continued to show a decline of a couple tenths, from 3.7% to 3.5%, as expected.

- The projections for 2020 and 2021 were marked up a tenth, to 3.6% and 3.8%. Perhaps FOMC participants made this upward adjustment to reflect the downward revision to real GDP growth, though that downward revision was earlier in the forecast. In any case, we don't read too much into this.

- The longer-run unemployment rate edged down a tenth, to 4.4%. We'd expected that to edge down at some point, as the unemployment rate has remained well below the longer-run estimate with core inflation remaining subdued.

Inflation

- Projected core PCE inflation was marked down a tenth in each year. It's now projected to be 1.9% in 2018, and 2.0% in 2019, 2020, and 2021.

- We had anticipated that 2018 and 2019 would be marked down. Indeed, we'd anticipated that 2018 would be marked down a bit more, since we see the data in hand as pointing to 1.8%.

- The downward revisions to 2020 and 2021 core PCE inflation can perhaps be partially explained by the two-tenths narrower unemployment rate gap in those years (one-tenth higher unemployment rate and one-tenth lower longer-run level) as well as lower underlying core inflation, reflected in the downward revisions to 2018 and 2019.

- It's a bit strange to us that FOMC participants aren't projecting core inflation above 2.0% in any year. In any case, Powell continued to describe participants as projecting core inflation near 2%.

Table 1

Median of Projections of FOMC Participants

	2018	2019	2020	2021	Longer run
Growth of Real GDP					
December projections	3.0	2.3	2.0	1.8	1.9
September projections	3.1	2.5	2.0	1.8	1.8
*LH Meyer forecast**	*3.1*	*2.2*	*1.8*	*1.8*	*1.9*
Unemployment Rate					
December projections	3.7	3.5	3.6	3.8	4.4
September projections	3.7	3.5	3.5	3.7	4.5
*LH Meyer forecast**	*3.7*	*3.4*	*3.5*	*3.6*	*4.5*
Headline PCE Inflation					
December projections	1.9	1.9	2.1	2.1	2.0
September projections	2.1	2.0	2.1	2.1	2.0
*LH Meyer forecast**	*1.8*	*2.0*	*2.2*	*2.2*	*2.0*
Core PCE Inflation					
December projections	1.9	2.0	2.0	2.0	
September projections	2.0	2.1	2.1	2.1	
*LH Meyer forecast**	*1.8*	*2.0*	*2.2*	*2.2*	

Source: LH Meyer and Federal Reserve.

Projections of inflation and growth in real gross domestic product (GDP) are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

*LH Meyer forecast published December 14, 2018.

The Dots

The median dots moved down, largely as the market expected (two-hike 2019 median, slightly lower longer-run median).

- 2019: As widely expected, the median fell to two hikes. There are now an equal number on either side of the median (six for one/two hikes, six for three hikes). As a result, the mean also fell roughly 20 basis points. There is no longer any participant who projects more than three hikes.

- 2020: The additional hike in 2020 stayed in the median dots, but only barely: Eight participants have dots below the median.

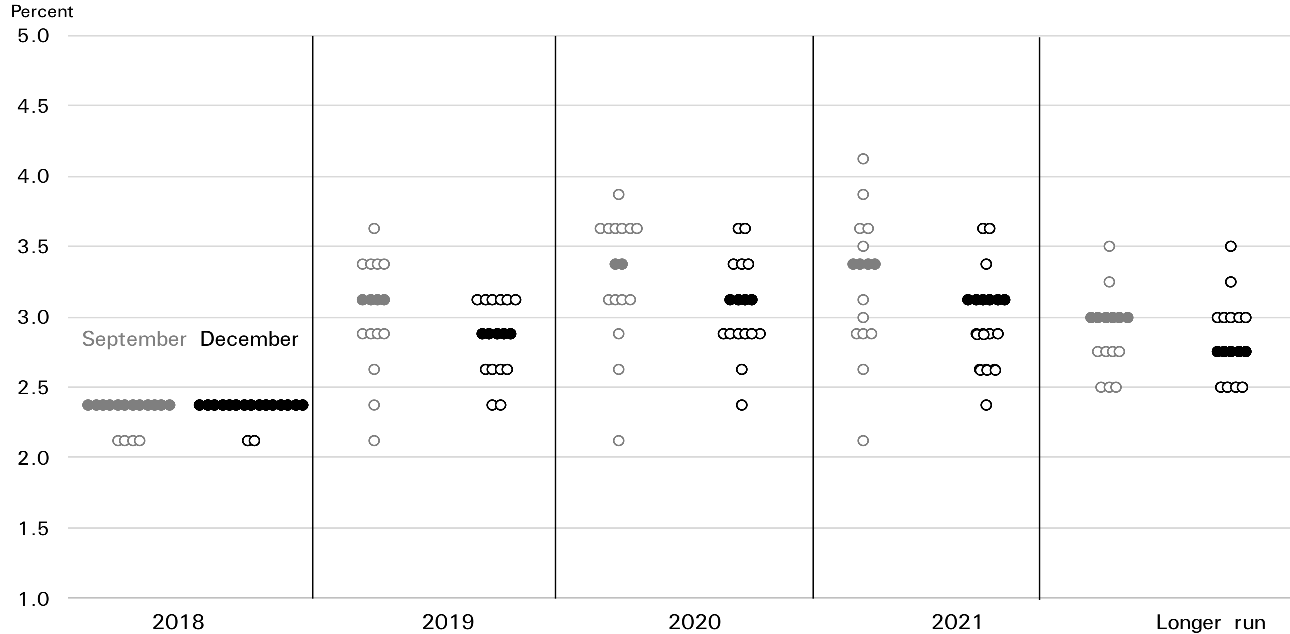
- 2021: The same story holds for the 2021 median, which is only one dot away from falling below 3.125%. Indeed, if one makes the assumption (not necessarily the case) that the n-th highest dots in 2020 and 2021 correspond to the same FOMC participant (Table 4), then the dots would suggest that four policymakers project a rate cut in 2021 and nobody projects a rate hike. (In contrast, under the same assumption, at least two in the Sep. SEP saw a rate hike.)

- Longer run: There was a shift in the median down to 2.75%, and the lower bound of the central tendency also declined, to 2.5%. The 25-basis-point downward shifts in these statistics notwithstanding, the downward shift in the longer-run dots was quite modest—the mean declined only 4 basis points.

- In the press conference, Powell stressed that the dots are neither a consensus nor a commitment. He cautioned against interpreting the median as a Committee view, because the SEP is merely a compilation of individual rate projections underpinned by individual macro projections. It was a warning against relying on the SEP estimates for signals about current or near-term policy instead of appreciating the data dependency of the rate path.

Figure 1

Evolution of FOMC Rate Projections



Sources: FRB, MPA.

Table 2

FOMC Participants' Projections for the Year-End Level of the Target Funds Rate

	2018	2019	2020	2021	Longer run
Dec. Median	2.375	2.875	3.125	3.125	2.750
Dec. Implied No. of Hikes	4	2	1	0	
Sept. Median	2.375	3.125	3.375	3.375	3.000
Sept. Implied No. of Hikes	4	3	1	0	

Source: MPA and Federal Reserve. Updated Dec. 19, 2018.

Table 3

Mean FOMC Participant Rate Projection

	2018	2019	2020	2021	Longer run
Dec. 2018	2.35	2.85	3.07	3.01	2.84
Sep. 2018	2.31	3.02	3.28	3.23	2.88
Jun. 2018	2.24	2.96	3.31		2.87
Mar. 2018	2.19	2.92	3.33		2.87
Dec. 2017	2.02	2.70	3.02		2.78
Sep. 2017	2.04	2.63	2.85		2.78

Sources: MPA, FRB.

Table 4

2020 and 2021 Dots

2020	2021	Change
2.4	2.4	0.00
2.6	2.6	0.00
2.9	2.6	-0.25
2.9	2.6	-0.25
2.9	2.9	0.00
2.9	2.9	0.00
2.9	2.9	0.00
2.9	2.9	0.00
3.1	3.1	0.00
3.1	3.1	0.00
3.1	3.1	0.00
3.1	3.1	0.00
3.4	3.1	-0.25
3.4	3.1	-0.25
3.4	3.4	0.00
3.6	3.6	0.00

Scenario assumes rank preservation.

Sources: FRB, MPA.

Additional Policy Elements

Balance sheet normalization

- While he noted "ongoing reduction in our portfolio" as part of the tightening process, Powell pointed out that the amount of runoff "so far is pretty small." Powell explained that the FOMC had decided that putting runoff on autopilot was the best option after learning that the market would very sensitive to any comments on balance sheet policy. He reaffirmed that the FOMC stands by that decision. He reiterated that policymakers would continue to rely on adjustments to short-term rates as the active lever of monetary policy. He also said that the QE models in reverse suggest little impact on broader macro conditions of runoff to this point and that other factors, such as increased bill supply, have had a much larger effect. The lack of any signal of openness to moderating the pace of balance sheet normalization perhaps disappointed the market.

IOER

- As telegraphed by the Nov. minutes, the Fed raised the IOER rate by only 20bps to 2.40%, to keep the effective funds rate "well within" its target range.

CCyB

- Powell noted his theoretical willingness to use the tool "as that test" is met, the requirement being that "financial stability vulnerabilities are meaningfully above normal." It does not appear that this test has been met yet, in his view. He cited his Nov. 28 speech, in which he assessed that those risks were "roughly at a moderate level," but nonetheless emphasized he had an open mind going into the annual determination, which will likely occur in January.

Press Conference

We saw Powell as under pressure at the press conference to defend why the Committee sees some further gradual rate hikes as appropriate given that they expect inflation to be no higher than 2%, they expect growth to slow markedly next year, financial conditions have tightened, and global growth has slowed. He was asked, why raise rates at all, given that inflation has undershot the 2% objective for seven years and is projected to do so again this year.

Powell said that, while growth is projected to slow, it is still expected to be at an above-trend rate in 2019, consistent with some further decline in the unemployment rate. Indeed, he called it a "strong" forecast. This was the "positive" outlook that warranted some further gradual rate hikes. Still, the Committee had responded to the tighter financial conditions by taking out a rate hike in 2019, and even so, they were still marking down growth.

What he did not do is defend the projected policy path in light of such well-contained inflation. He could have said that inflation is projected to remain so stable at 2% in participants' forecasts precisely because of the further rate hikes they projected. Without those rate hikes, the unemployment rate would move down even further. But that would have raised even more questions. It sure looks like the FOMC is defending a 2% inflation objective, treating it as a ceiling, rather than behaving as if it were a symmetric objective.

Powell apparently came into the press conference planning to repeat again and again the idea that, with the December hike, the FOMC is now at the bottom end of "the broad range of neutral." He managed to get it in at least three times! That's important because he and others have said that once the funds rate gets to this range, policy becomes even more data dependent and hence the timing of the next hikes becomes even more uncertain.

Based on the relevant range being 2½%-3½%, getting inside the range would mean the target funds rate range getting to 2½%-2¾%, or after a March hike. Now, we are a bit more uncertain about whether there will be a March hike, if Powell is comfortable describing the current 2.25-2.5% setting as the funds rate being "at the bottom end of the range." Powell also said tepid inflation and being inside the range of neutral gives the FOMC "the ability to be patient in moving forward." He added that there is "a fairly high degree of uncertainty about any further increases." While overall Powell's press conference constituted a defense of the FOMC's ongoing rate hikes, these specific remarks at the press conference were notably dovish relative to the "some further gradual increases" in the statement and the dots.

On whether the dot plot would be amended, he suggested that the dots are here to stay. In his view, they play an important role in providing information about individual policymakers' reaction functions. But he stopped short of presenting the dots as an important source of forward guidance, especially now that strong forward guidance is being removed from the statement. He warned against interpreting the median as a consensus forecast.

Powell said that having press conferences at every meeting beginning in 2019 would be a great gain for communication. He seemed to admit that, the protests of policymakers notwithstanding, non-press-conference meetings haven't been live to this point. He argued that the distinction between SEP and non-SEP meetings would become irrelevant for the purposes of timing rate hikes. We disagree. It is true that press conferences will raise the likelihood of moves at non-SEP meetings, but SEP meetings will remain the preferred time for policy moves.

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From a "Long Way from Neutral" to "Just Below the Broad Range" of Neutral Estimates
FOMC Minutes: Not Yet Concerned, But Alert
FOMC Statement: Nothing to See; Wait for the Minutes

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